

# Global Fixed Income Program Review

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Global Fixed Income

November 14, 2011

# Vision of Global Fixed Income

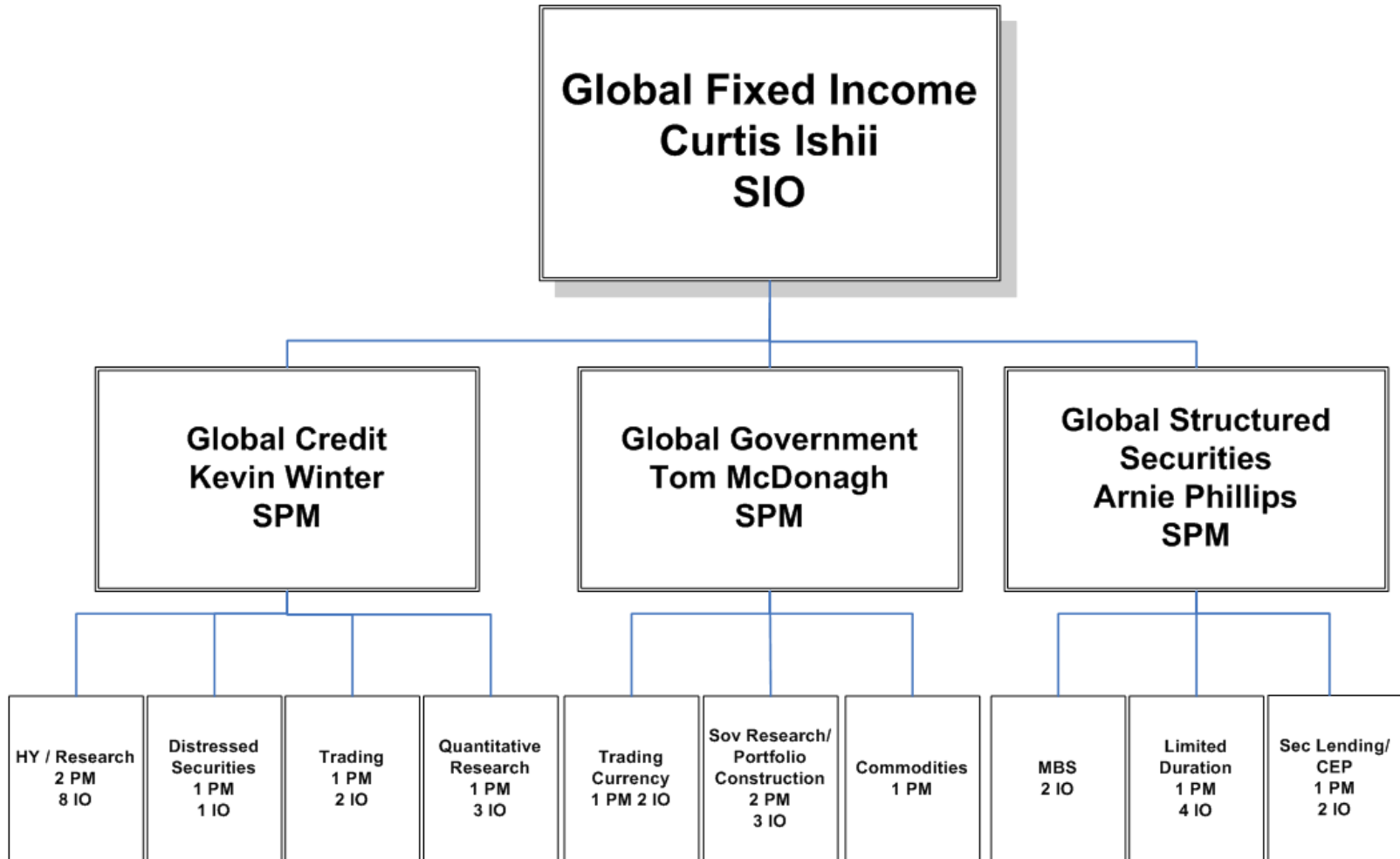
- In-source when it makes sense
- Continue with existing strategy as 25-year history validates process
- Continue to attract, retain, and develop staff

# Purpose of the Program Review

- Summary of Performance for Global Fixed Income
- Changes in the Risk Profile of Global Fixed Income
- Review of other programs managed by Global Fixed Income
- Initiatives for the next 12 months

# Organization Chart

(Investment Professionals)



# Global Fixed Income Characteristics

(as of 9/30/11)

GFI represents 19% or \$42 billion of the CalPERS total fund

- 17% Domestic Fixed Income (DFI) composition
  - US Governments
  - Investment Grade Corporate Credit
  - Structured Securities- mortgage backed securities
  - Sovereigns- IG International Government
  - Cash
  - Opportunistic
- 2% International Fixed Income
- < 1% Special Investment- MHLF

# Basic Strategies for Fixed Income

- Long term investor that focuses on shifting risks within an economic cycle
  - Acknowledge difficulty in calling absolute bottoms or tops
  - Fundamentally driven approach with a proven framework
  - Acknowledgement that PMs' bias is to be early; thus, PMs average into a trade or strategy
  - CalPERS long term focus, averaging in, and lack of leverage allows the portfolio to withstand short term volatility and forced selling at inopportune times

# Basic Strategies for Fixed Income

(continued)

- Cost of internal management is small at 1-3 bp, in-source if skill sets are available in-house
  - Estimated cost of external management is 20-30 bp
- Key assumption of internal management is the ability to attract and retain investment professionals. This is done through the following:
  - Creating an environment focused on investing and managing assets
  - Trying to pay competitive compensation packages
  - Leveraging on CalPERS reputation as a large, sophisticated investor

## Long-Term Performance Validates Fixed Income Strategy

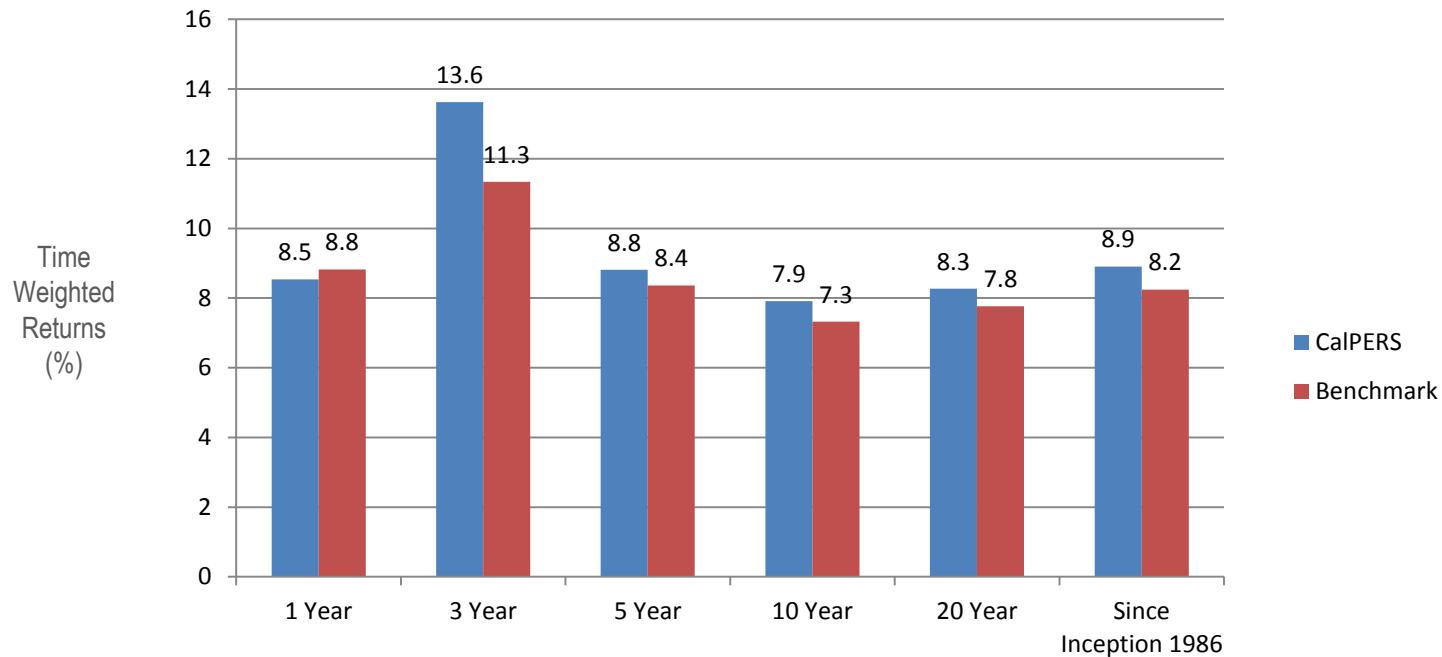
- Since inception date of existing management (June 1986), Domestic Fixed Income has created positive excess return (alpha) in 19 out of 26 fiscal years and an average annual alpha of +55 basis points (bp)
- 38 professionals (traders, analysts, and portfolio managers) in a number of FI markets
  - Provides market intelligence for FI and total fund
- As of 9/30/11, 89% of funds managed internally



# Global Fixed Income Performance

(U.S. and International as of 9/30/11)

*Good Long Term Results*



91% US Fixed Income, 9% International Fixed Income

# Global Fixed Income Detailed Composition

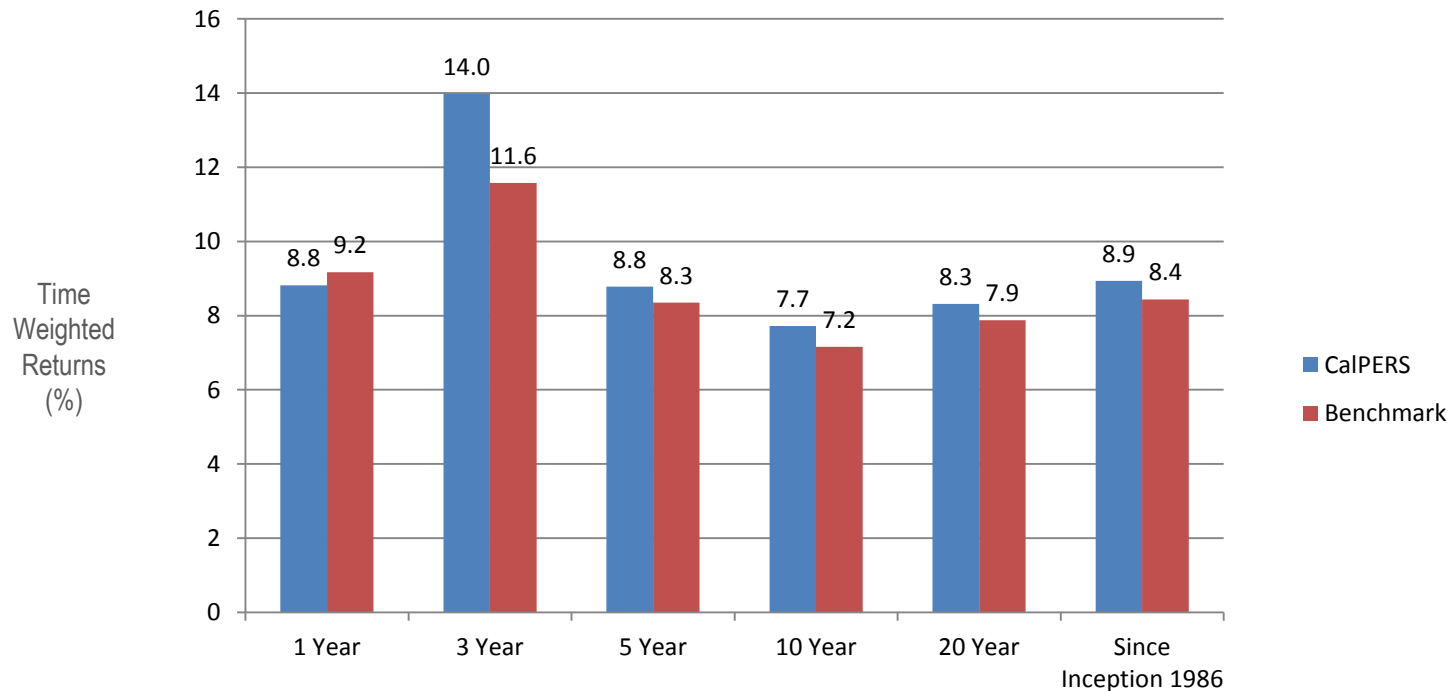
(as of 9/30/11)

	Market Value (\$ bn)	%NAV		
		CalPERS	Bench	Active
Domestic Fixed Income	\$38.3	90%	89%	+1%
U.S. Governments	14.5	34	35	-1
Credit	8.8	21	21	0
Structured Securities	11.4	27	27	0
Sovereigns	0.9	2	3	-1
Opportunistic		5	3	+2
High Yield Credit	1.7	4	3	N/A
Non-Credit Opportunistic	0.6	1	0	N/A
Cash Securities	0.4	1	0	+1
<b>International Fixed Income</b>	3.6	9	11	-2
<b>Special Investments</b>	0.6	1	0	+1
<b>Total Global Fixed Income</b>	<b>\$42.5</b>			

# Domestic Fixed Income Performance

(as of 9/30/11)

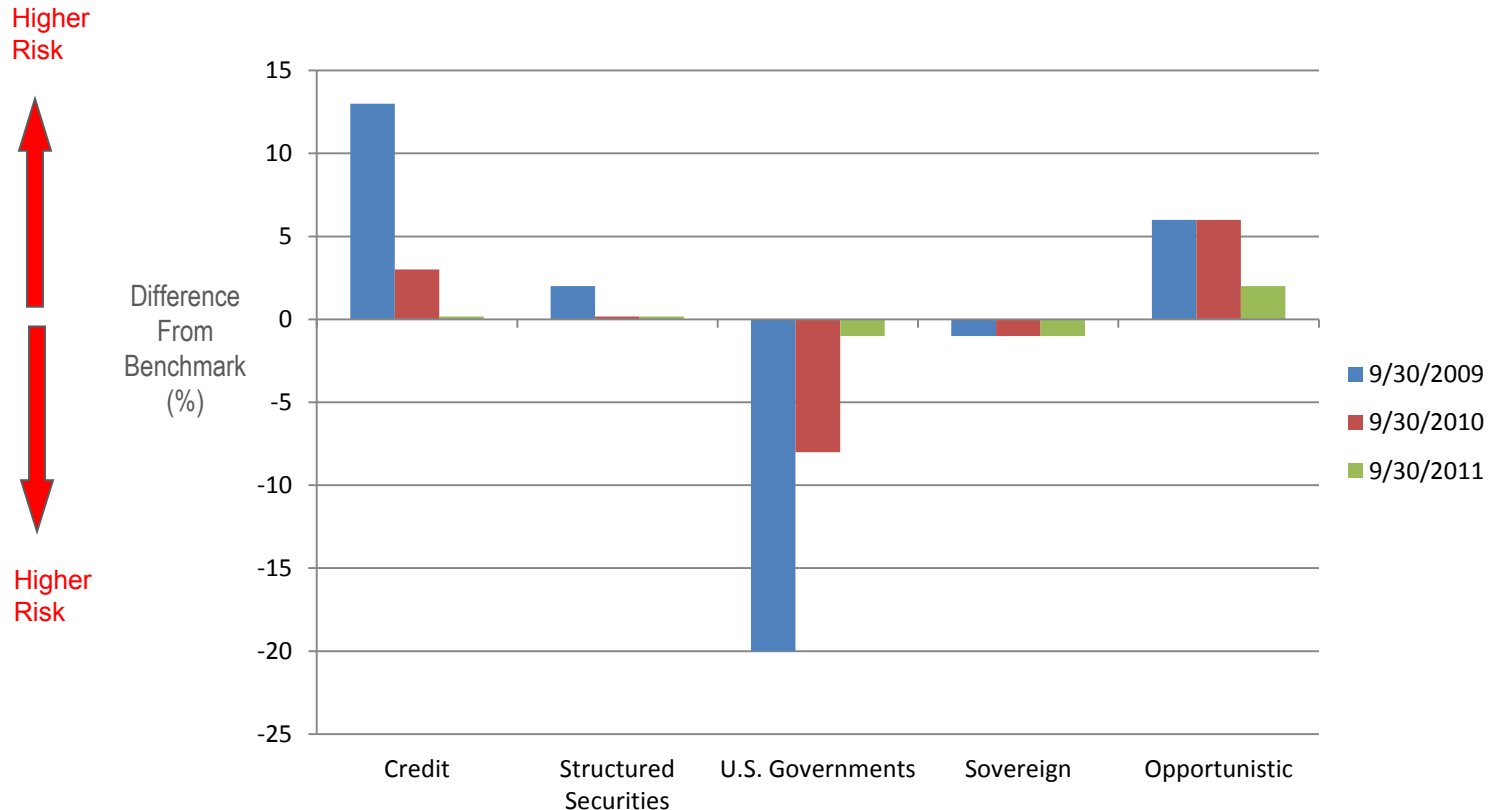
*Good Long Term Results*



# Sector Risks: Smaller Gaps Equal Lower Risk

(as of 09/30/11)

## *Fixed Income Sectors Gap Relative to the Index*



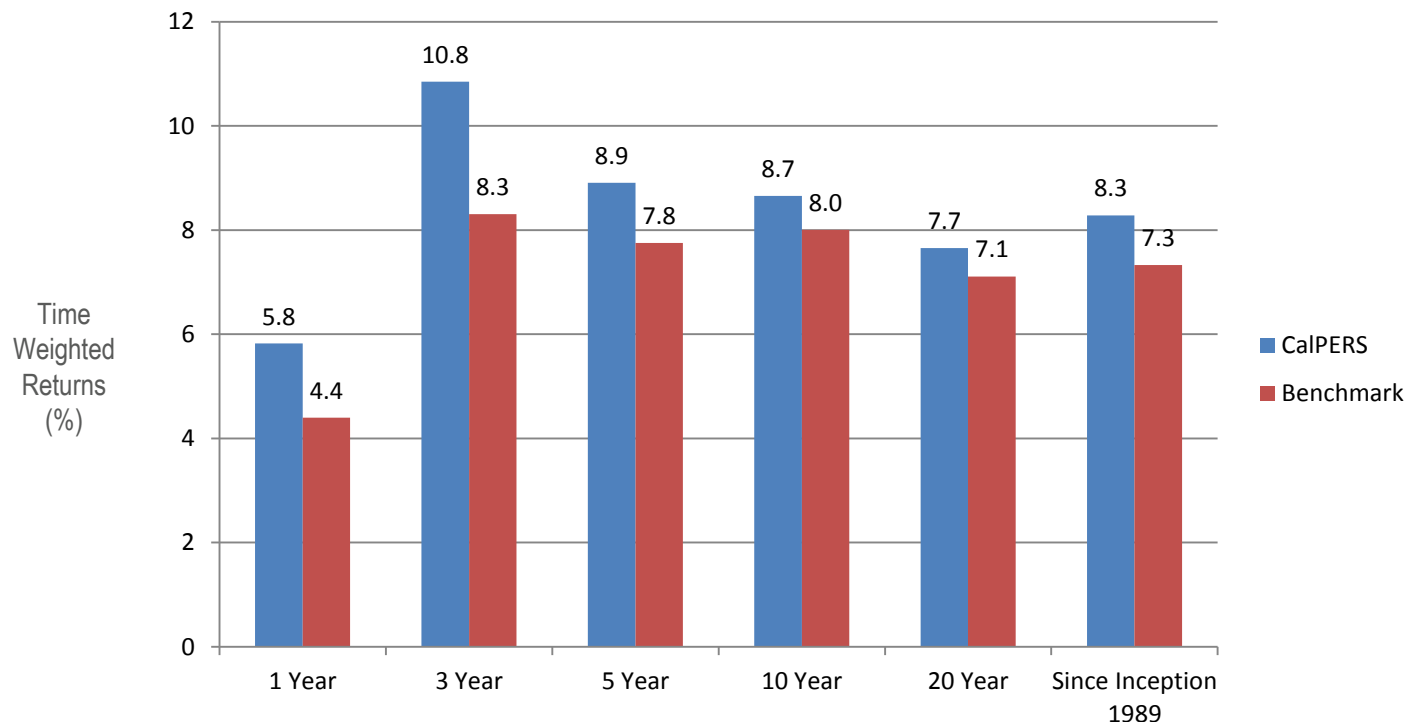
# International Fixed Income

- 2% or \$3.6 billion of CalPERS total fund as of 09/30/11
- Managed by 4 external managers
  - PIMCO
  - Baring Asset Management
  - Rogge Global Partners
  - Alliance Bernstein

# International Fixed Income Performance

(as of 9/30/11)

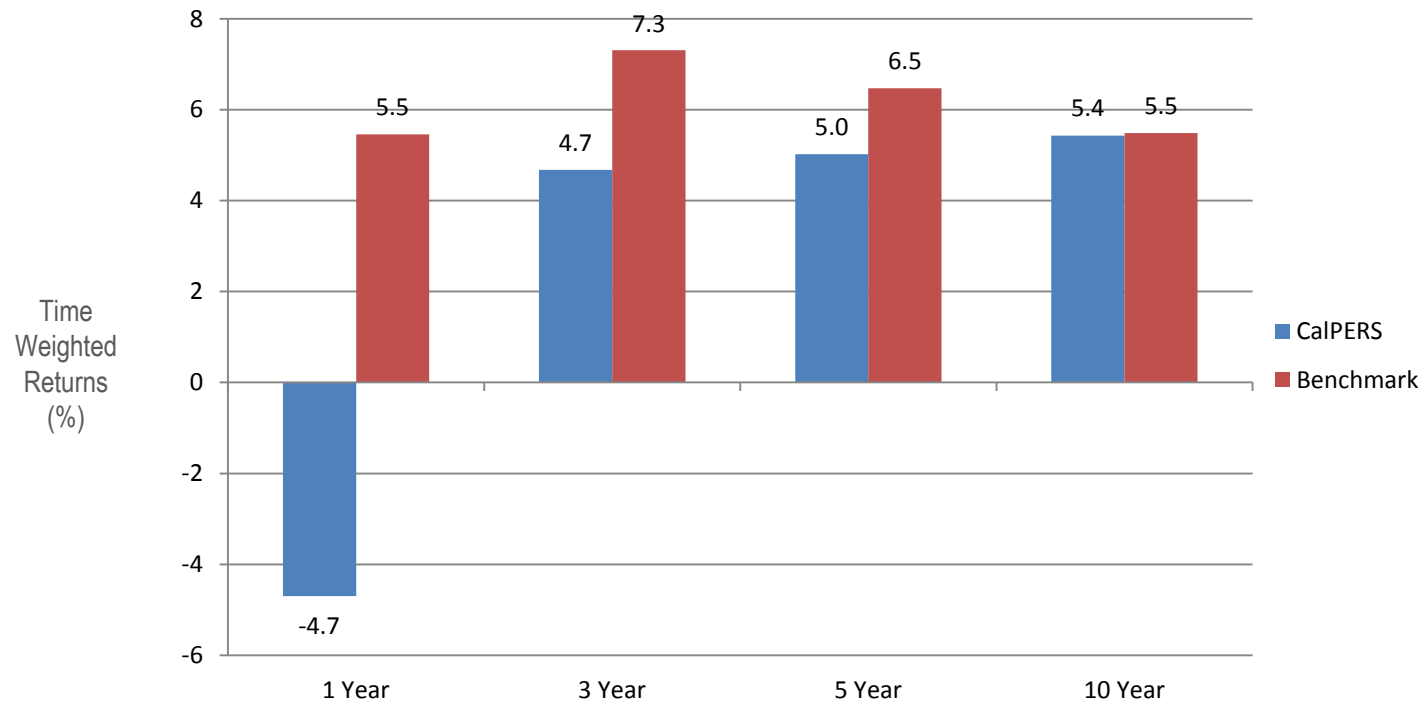
*Good Short and Long Term Results*



# Special Investments – MHLP

(as of 9/30/11)

*Poor Results Validate Elimination of Program*



# Other Programs Managed by Global Fixed Income

(as of 9/30/11)

Total amount of assets for other programs managed by Global Fixed Income represents \$44.4 billion

- Inflation
  - Inflation-Linked Bonds Program (\$4.8 bn)
  - Commodities Program (\$2.2 bn)
- Affiliate Funds
  - Treasury Inflation Protected Securities Program (\$0.5 bn)
  - Affiliate Internal High Yield Program (\$0.3 bn)
  - Barclays Aggregate Program (\$0.7 bn)
- Liquidity
  - U.S. Treasuries 2-10 Year Program (\$6.2 bn)
  - Short Term Program (\$1.5 bn)
- Sec. Lending-Related
  - Sec. Lending Program
  - Sec. Lending Collateral (including the Limited Duration Program) (\$11.9 bn)
- Other
  - Currency Overlay Program (\$11.8 bn)
  - Credit Enhancement Program (\$1.5 bn)
  - Synthetic Enhanced Equity Program (\$3.0 bn)



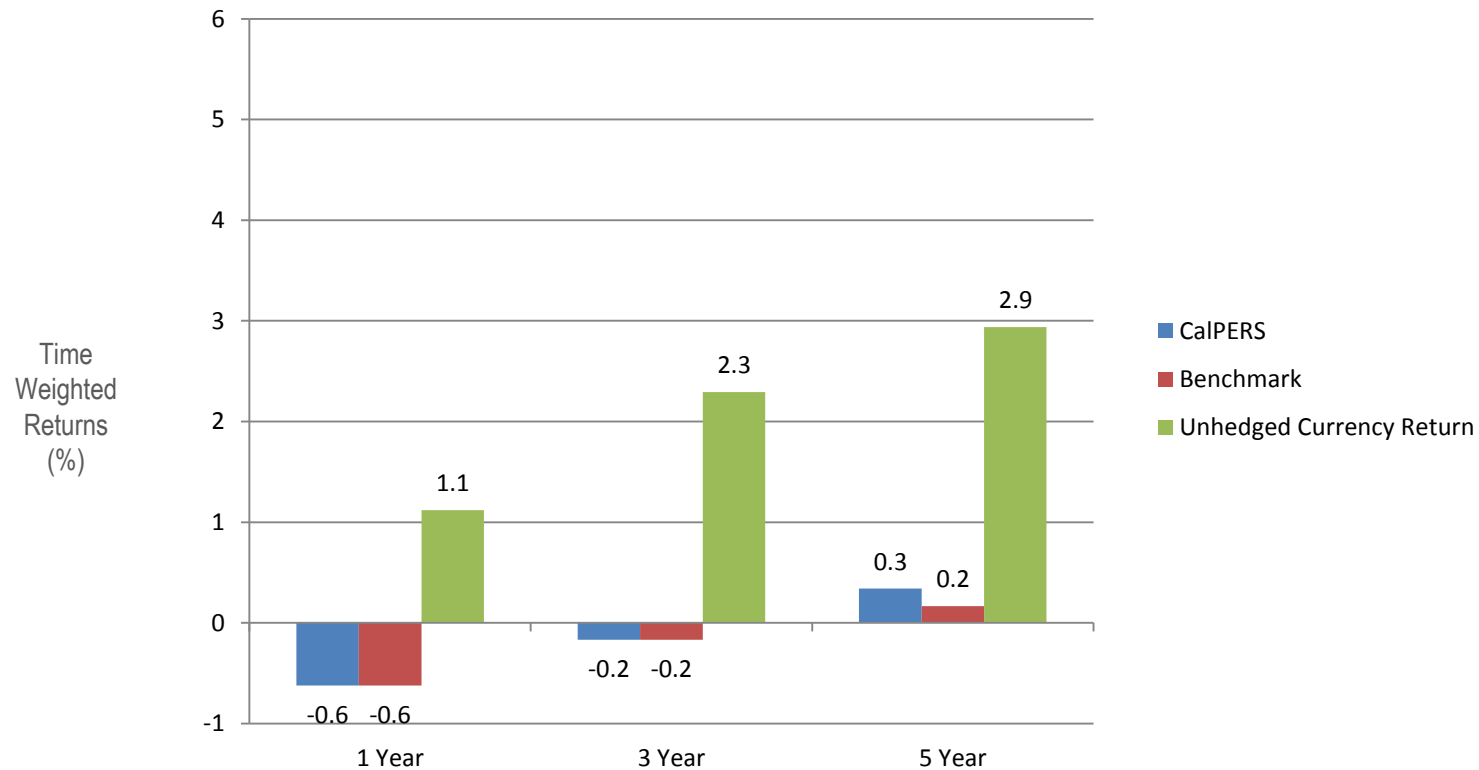
Currency Overlay Program  
Inflation-Linked Bonds Program  
Commodities Program  
Treasury Inflation Protected Securities Program  
U.S. Treasuries 2-10 Year Program

Thomas McDonagh  
SPM, Global Government

# Currency Overlay Performance

(as of 9/30/11)

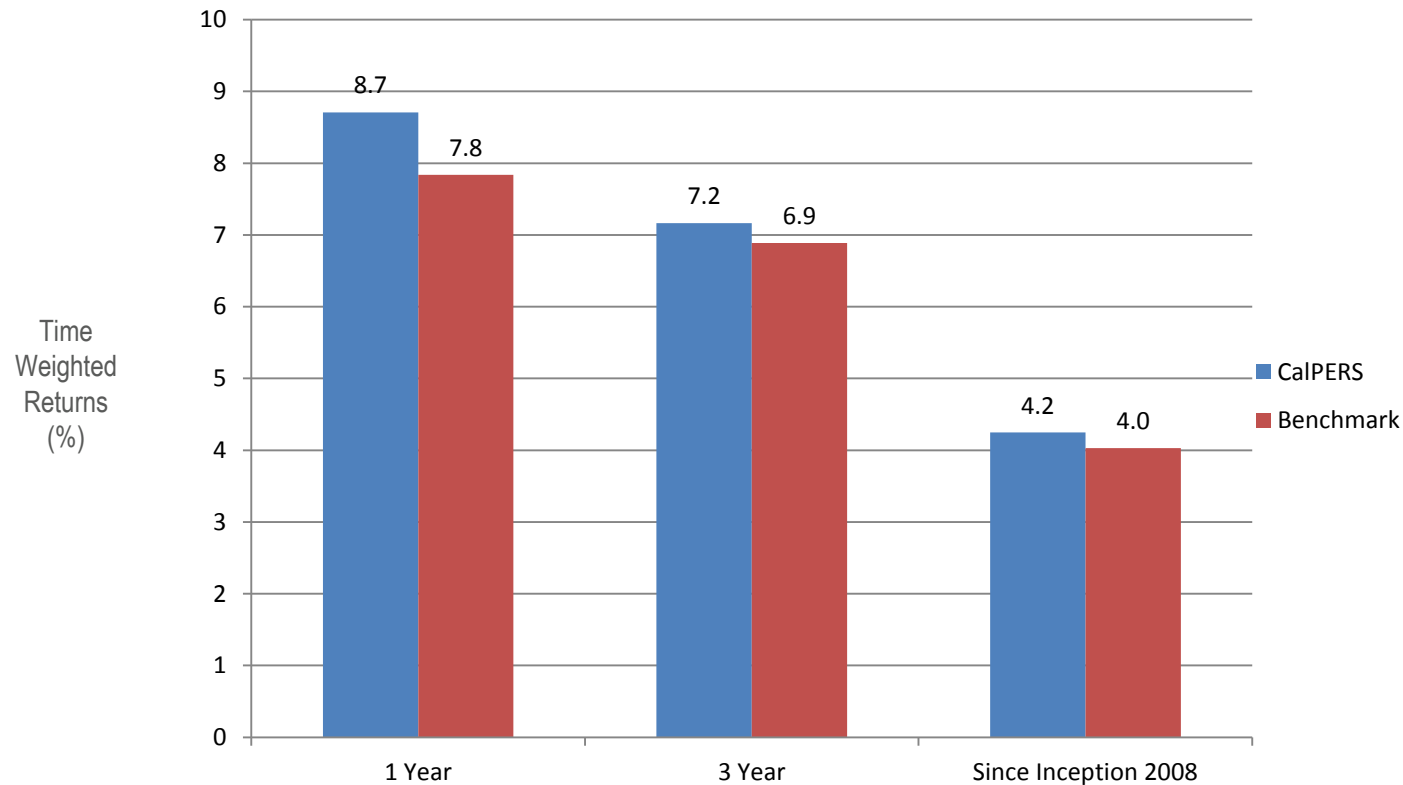
## Benchmark Returns



# Inflation-Linked Bonds Performance

(as of 9/30/11)

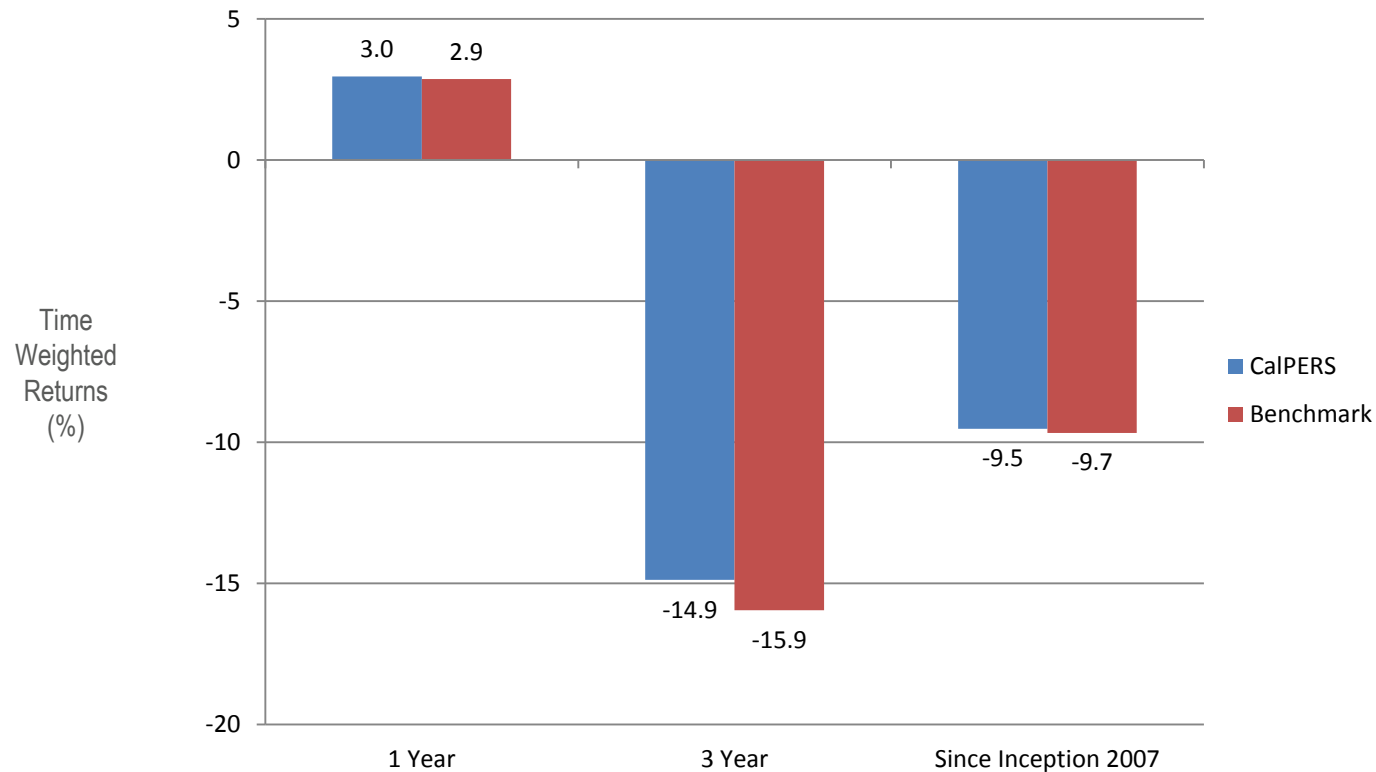
*Good Short and Long Term Results*



# Commodities Performance

(as of 9/30/11)

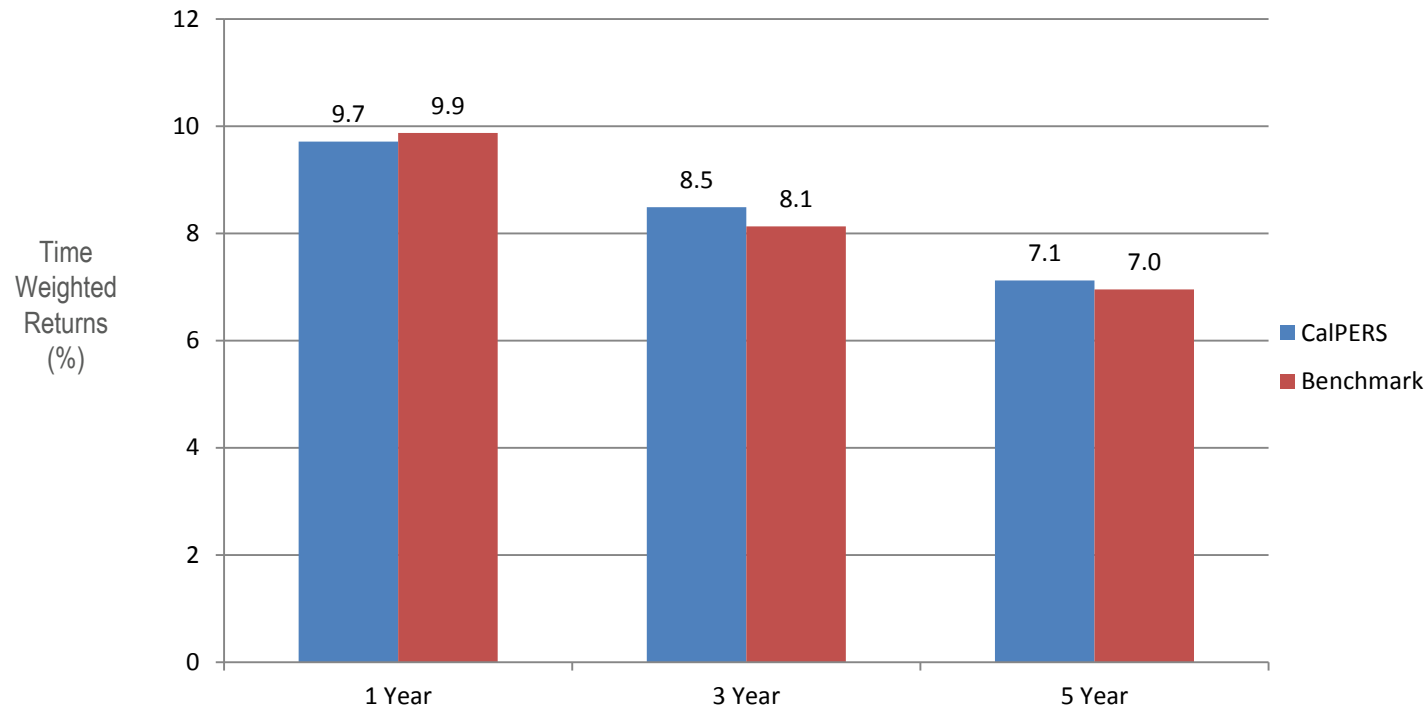
## *Good Short and Long Term Relative Results*



# Treasury Inflation Protected Securities Performance

(as of 9/30/11)

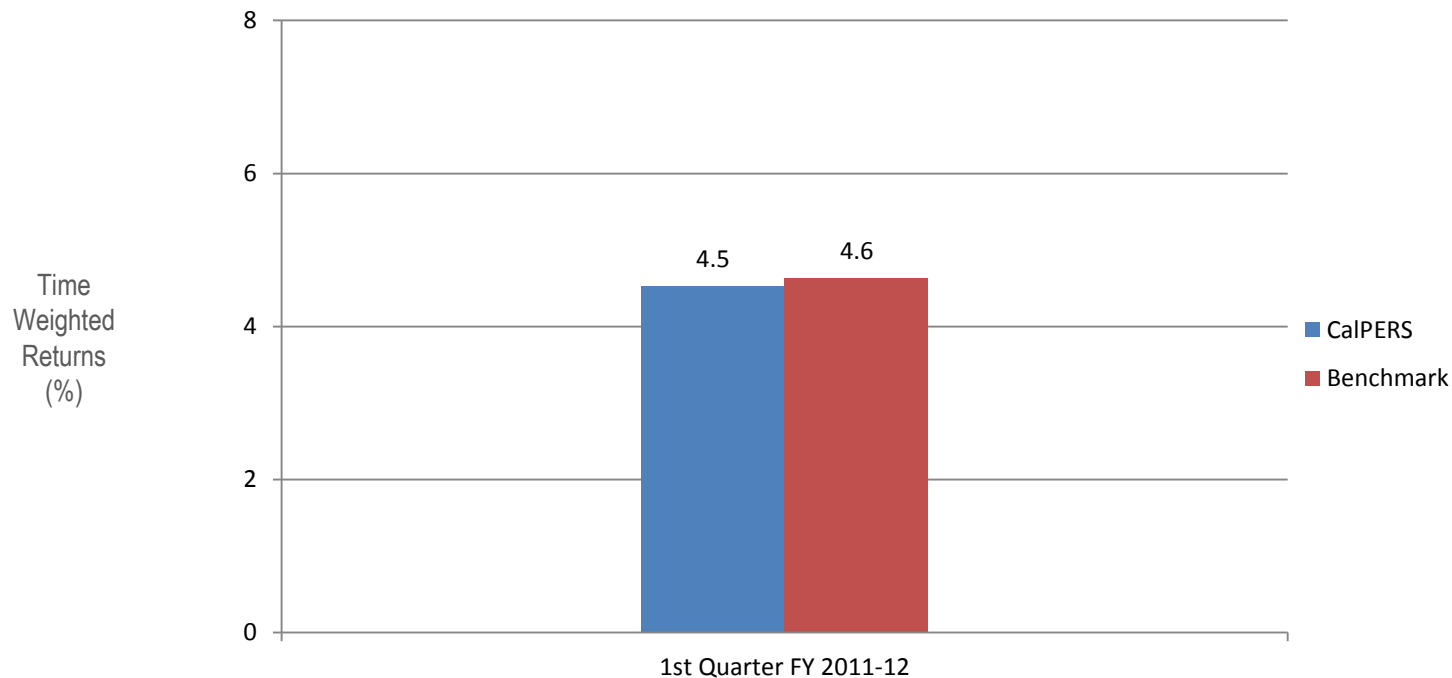
*Good Long Term Results*



# U.S. Treasuries 2-10 Year Performance

(as of 9/30/11)

*Limited Data*



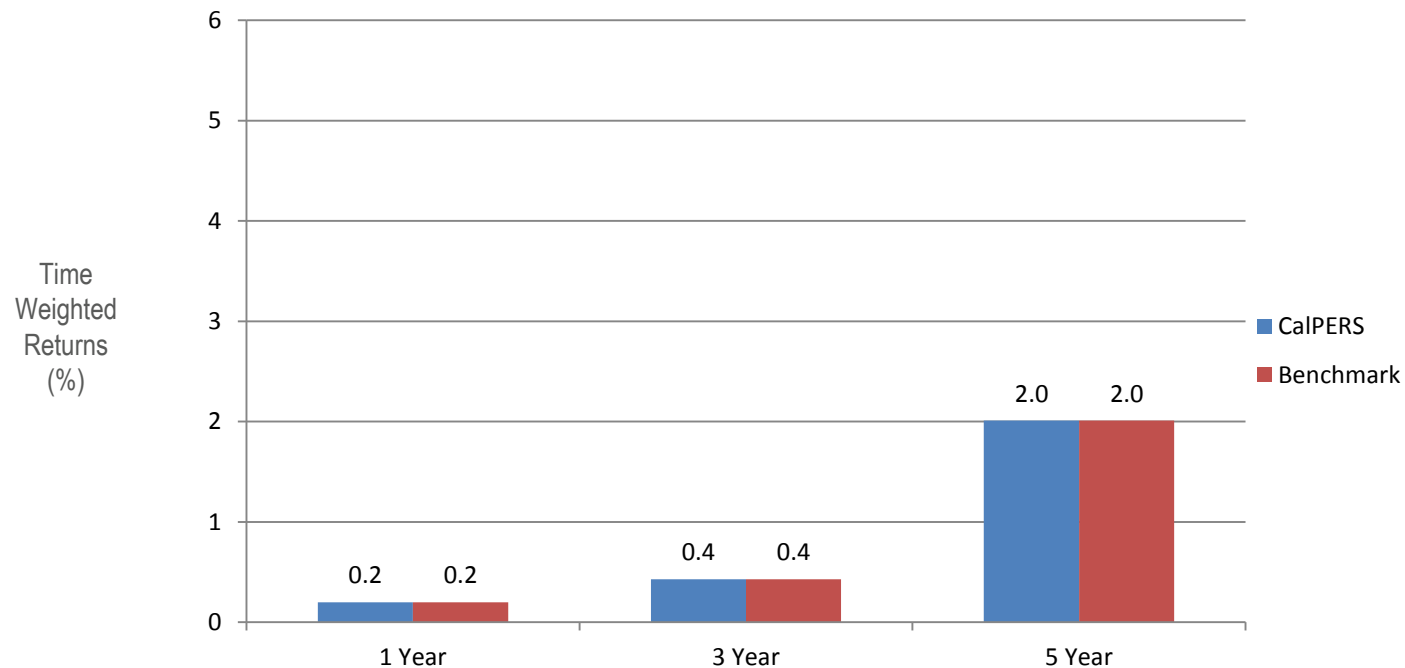
Inception date of fund is 07/01/2011

Short Term Program  
Sec. Lending Program  
Sec. Lending Collateral (including the Limited Duration Program)  
Credit Enhancement Program  
Synthetic Enhanced Equity Program  
Arnie Phillips  
SPM, Global Structured Securities

# Short Term Performance

(as of 9/30/11)

## *Benchmark Returns*





# Sec. Lending Program Earnings

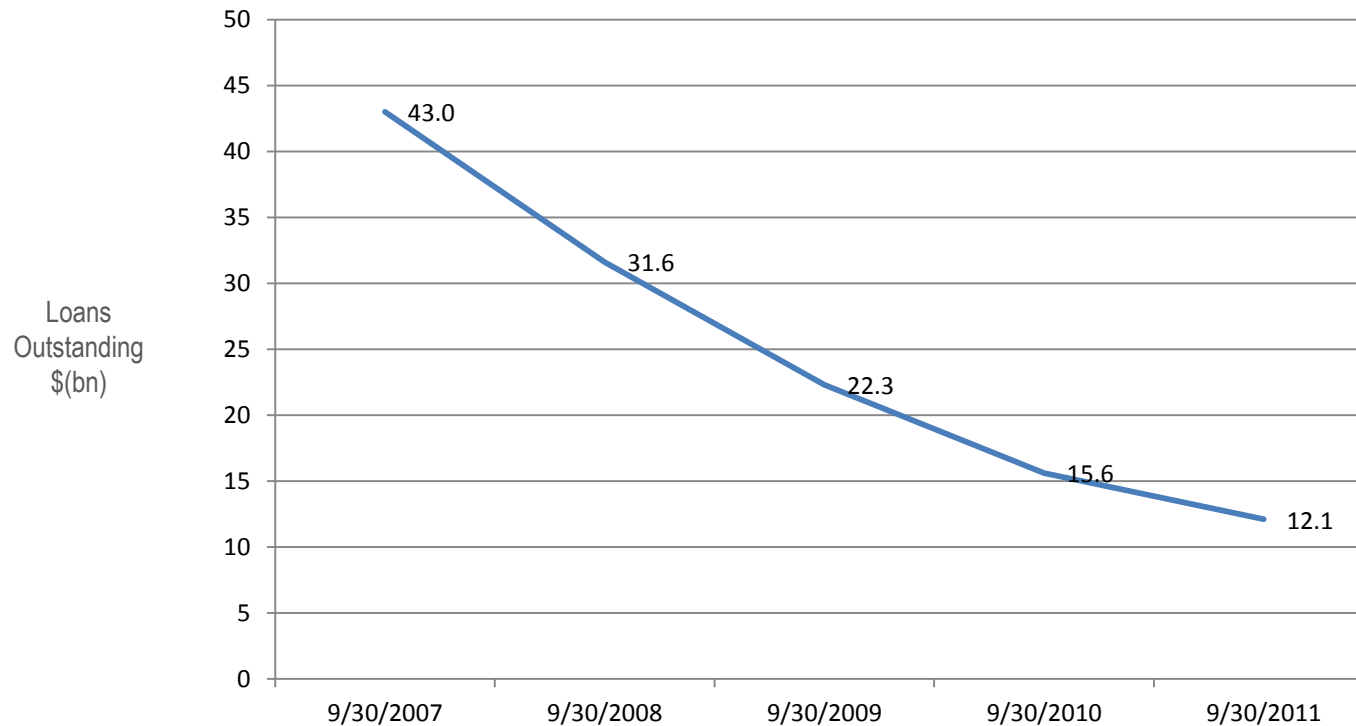
(as of 9/30/11)

	Sec. Lending Loan Income (\$ mm)	Sec. Lending Reinvestment Income (\$ mm)	SIV Realized Losses (\$ mm)	Total Earnings (\$ mm)
Oct 2006 - Sept 2007	\$126.8	\$16.9	\$0.0	\$143.7
Oct 2007 - Sept 2008	110.6	(481.3)	0.0	(370.7)
Oct 2008 - Sept 2009	88.5	164.3	(225.0)	27.8
Oct 2009 - Sept 2010	87.6	436.7	(553.9)	(29.6)
Oct 2010 - Sept 2011	92.1	93.5	0.0	185.6
5 Yr Totals	\$505.6	\$230.1	(\$778.9)	(\$43.2)

# Sec. Lending Program

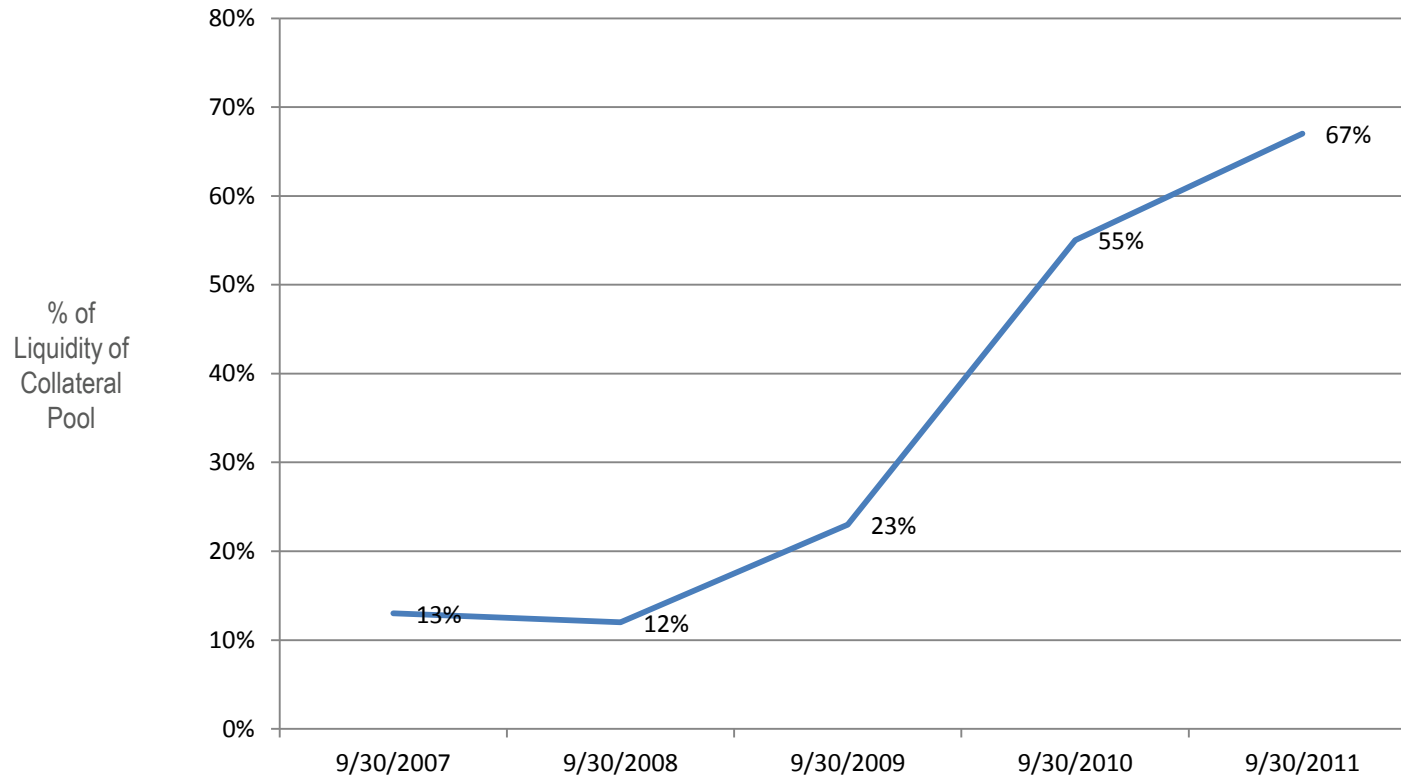
(continued)

*Part of Overall Risk Reduction*



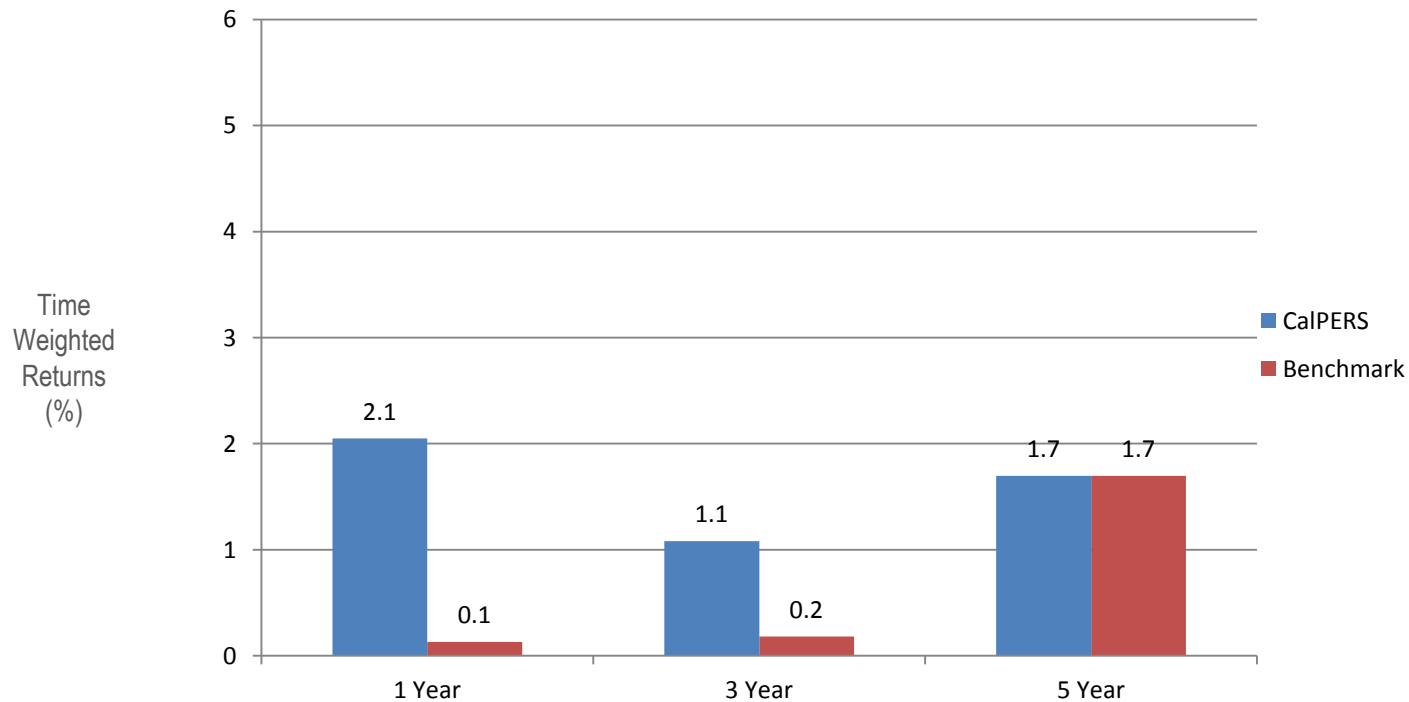
# Sec. Lending Collateral (including the Limited Duration Program)

*Increase CalPERS Liquidity*



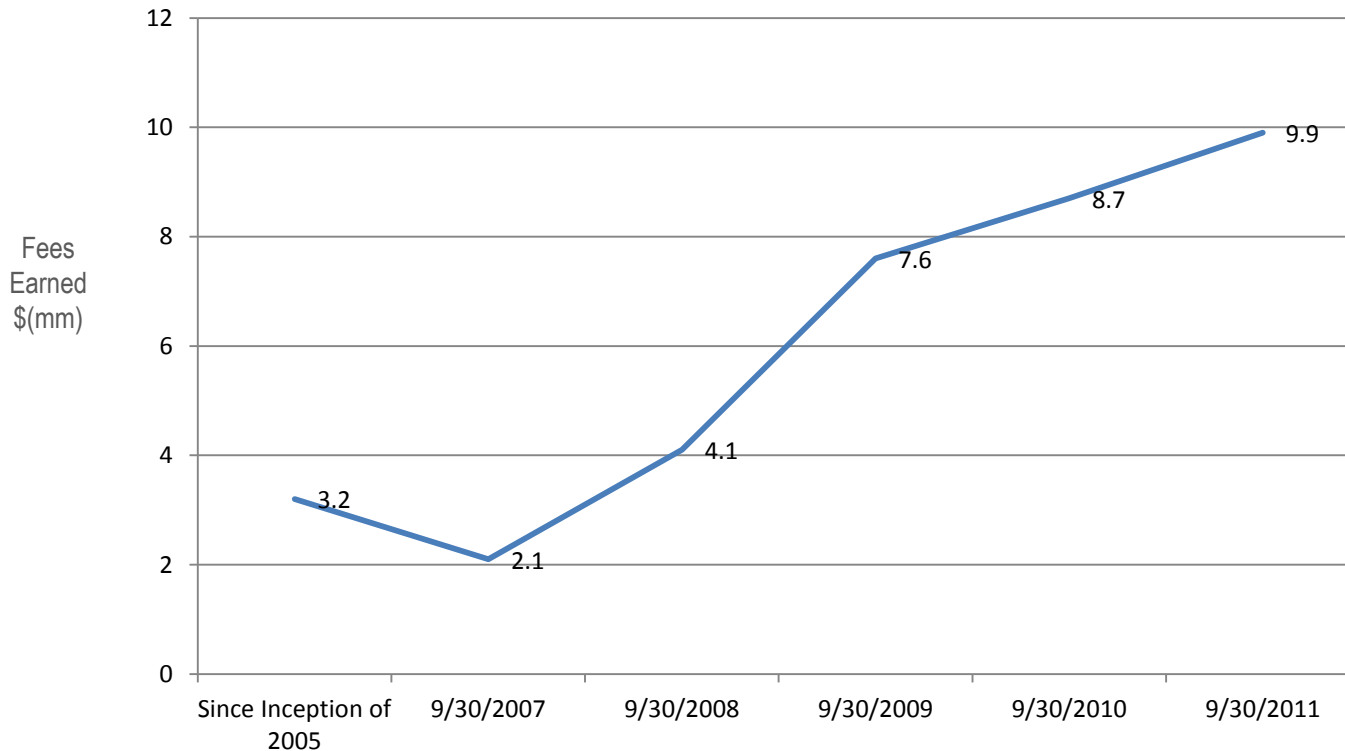
Note: Liquidity defined as one-month or less maturity

## Sec. Lending Collateral (including the Limited Duration Program) Performance (as of 9/30/11) *Good Short and Long Term Results*



# Credit Enhancement Program

*Currently in More Favorable Market*



# Synthetic Enhanced Equity Program

- Began June 2009
- Uses limited duration fixed income securities and overlay of equity derivatives
- Return enhancement from fixed income results in excess of cash returns
- Initial value was \$1.5 billion, currently \$3.0 billion
- Cumulative return through 09/30/11 is +36.3% versus +25.0% domestic equity benchmark
- 11.3% excess return = more than \$170 million value added

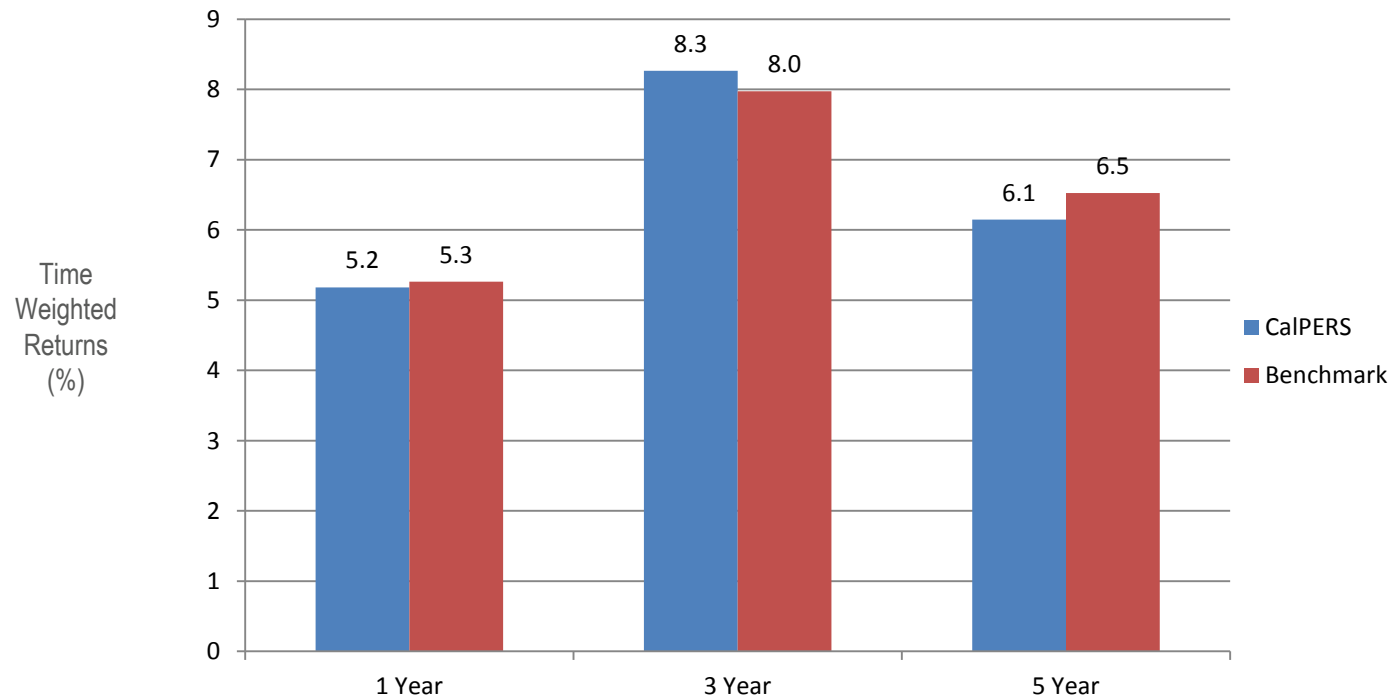
# Barclays Aggregate Program Affiliate Internal High Yield Program External Managers

Kevin Winter  
SPM, Global Credit

# Barclays Aggregate Performance

(as of 9/30/11)

*Mixed Results*

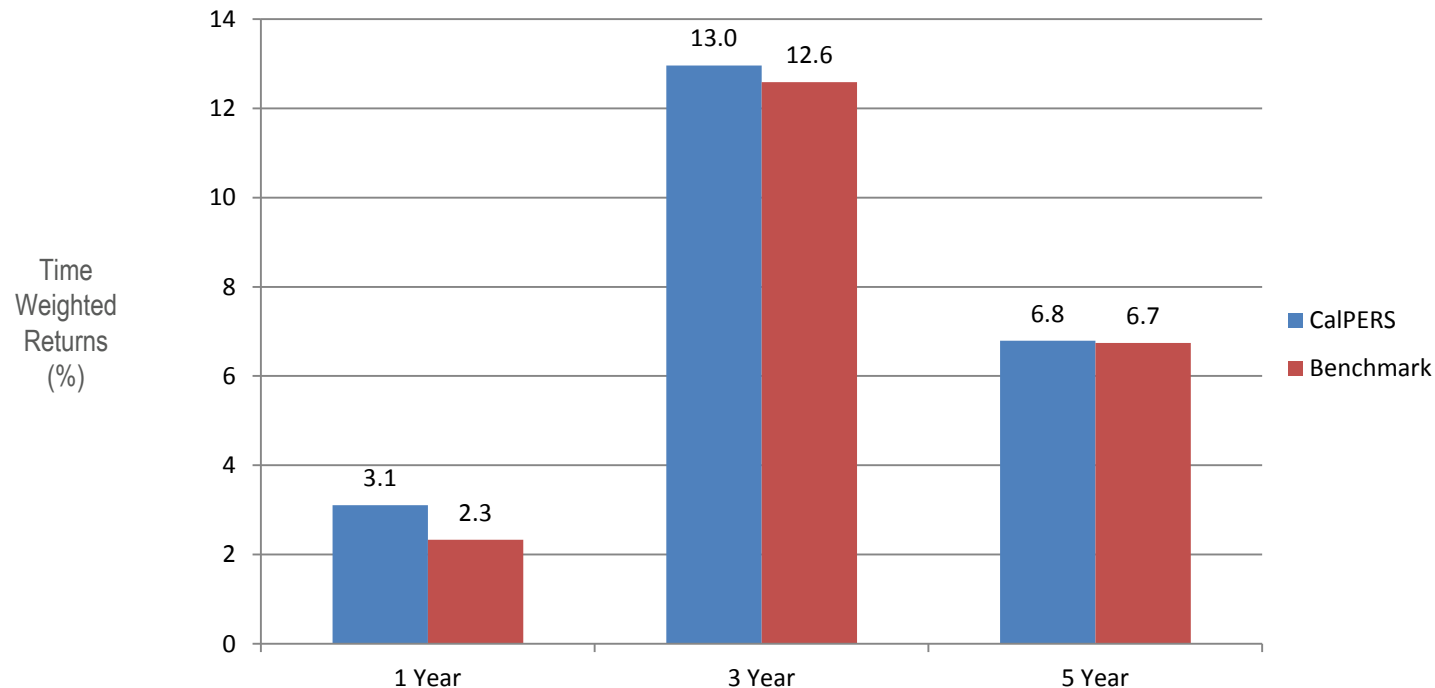




# Affiliate Internal High Yield Performance

(as of 9/30/11)

*Good Short and Long Term Results*



# External Managers

- Purpose
  - Provide skill sets not available internally
  - Supplement information, knowledge, and skills that internal staff can convert to alpha for internal programs
- Utilized in Currency Overlay, International Fixed Income, and High Yield
- All contracts can be terminated within 30 days notice

## External Managers – Action Item

- Recommend approval for renewal
  - External managers enhance Global Fixed Income's diversification and alpha objectives
  - This recommendation for renewal includes high yield bond and loan managers that are not currently managing money (TCW, ING, Putnam, Columbia LL, JP Morgan, Artio Global)
  - See ATTACHMENT 2 for details of individual external manager performance returns

# Keys for Internal Management of Fixed Income

- Attracting investment professionals
  - Hired 2 PMs: Commodities and Sovereign with an average of 20 years of industry experience each
  - Based on recent history, it takes about an average of 10 months to fill one PM position
  - Hired 6 IOs as either a credit, quantitative, or structured security analyst/trader with an average of 7 years of industry experience each
  - Based on recent history, it takes about an average of 7 months to fill one IO position
- Retaining key staff
  - 3 SPMs and 1 SIO have an average of 20 years of CalPERS employment each
  - FI has 38 investment professionals with an average of 14 years of industry experience each. 60% of this experience is with CalPERS
- Training
  - Need to invest in sending staff to training: at conferences, with our external managers, and with broker/dealers

# Priorities for the Next 12 Months

- **First Priority** – Manage Global FI to create targeted alpha by continuing the existing and proven long term fundamental focused style
- Portfolio initiatives
  - Subject to IC approval, internally manage \$1 billion of international FI
  - Continue to in-source short term funds primarily in the Global Equity and Sec. Lending Programs
  - Continue to explore portable alpha opportunities
  - Graduate currency alpha pilot program and increase funding
- Governance initiatives in conjunction with Corporate Governance
  - Work with SEC to make changes in bondholders rights
  - Work with governmental institutions on mortgage reform
  - Work with governmental institutions on rating agency reform

# Priorities for the Next 12 Months

(Continued)

- Total Fund initiatives
  - Begin constructing a total fund attribution system to supplement the one developed for Global Fixed Income
  - Working with Asset Allocation/Risk Management and Investment Servicing Units to enhance investment operational infrastructure
- Attract and retain talent
  - Per search firms, 90% initial turndown rate due to compensation for PMs and above
  - Based on recent history, it takes about an average of 10 months to fill one PM position
  - Based on recent history, it takes about an average of 7 months to fill one IO position
  - Fill economist/analyst PM and 3 IOs
  - Through the budget process get additional IOs for research and trading
  - Set aside time and money to invest in staff development

# Summary

- Good relative and absolute returns for GFI
- \$8 billion In-Sourcing or expanding of existing portfolios
- Continuing the strategy of long term fundamental focus and alpha creation